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Congressional Flak

Rating Agencies Under Fire in House

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By Andrew Ackerman

WASHINGTON - Members of the House Committee on Oversight and Government Reform blasted the major rating agencies for their role in the financial crisis yesterday, claiming internal memos showed they knew the entire financial system could be placed in jeopardy because of their unduly high ratings for subprime-related debt.

The lawmakers voiced their criticisms at a hearing, during which panel member Rep. Diane Watson, D-Calif., asked officials from Standard & Poor's, Moody's Investors Service, and Fitch Ratings about California Treasurer Bill Lockyer's complaints that the agencies rate corporate debt higher than municipal debt, despite lower muni bond default rates. She asked each agency to submit in writing what standards they use to rate municipal bonds.

Questioning Standard & Poor's president Deven Sharma, Watson asked how the rating agency could give the same A-plus ratings to California and Lehman Brothers, just before Lehman's holding company filed for bankruptcy last month.

Sharma pointed to the state's budget shortfall, which he said had risen from $22 billion to $23 billion, then noted that at the time Lehman was trying to raise capital and told Standard & Poor's that it would be able to do so and that it had a backstop from the Federal Reserve, among other things.

"This is why we felt they could be an ongoing entity," he said of Lehman.

Watson asked if the agency rates corporate debt higher than municipal bonds, to which Sharma said: "We have a single global consistent scale and we strive for global consistency." He added: "We do look at different criteria. However, from a scale point of view, we have the same criticality."

The exchange on munis came toward the end of the nearly five-hour hearing, which focused mostly on the accuracy of the agencies' ratings for structured products.

"The story of the credit rating agencies is a story of colossal failure," said committee chairman Henry Waxman, D-Calif., adding that they broke a "bond of trust" with "millions of investors" who relied on them for independent, objective assessments. Waxman also criticized federal regulators, particularly the Securities and Exchange Commission, saying the SEC "ignored the warnings signs and did nothing to protect the public."

Waxman is due to hear from SEC chairman Christopher Cox today in a hearing on the roles the federal agencies played in the financial crisis.

Rep. Christopher Shays, R-Conn., complained that because issuers pay for ratings from the major agencies, their ratings are compromised. "When the referee is being paid by the players, no one should be surprised when the game spins out of control," he said. "That's what happened on Wall Street, when credit rating agencies followed the delirious mob on mortgage-backed securities and sold their independence to the highest bidder." The rating agencies apply the issuer-pays model to muni as well as structured products.

Jerome Fons, a former executive with Moody's, testified during the hearing that the issuer-pays model and rating shopping by issuers create conflicts of interest. He also said the major banks would play one rating agency off another because of the opacity of structured transactions and the potential for high fees. For months, congressional leaders have accused the rating agencies of giving triple-A ratings to structured products that turned out to be junk. The products, such as residential mortgage-backed securities and collateralized debt obligations backed by RMBS, were created by financial institutions to mitigate risk on the underlying loans by packaging them into pools and selling them to multiple investors. But as borrowers defaulted on the mortgages, many of which were given to people with bad credit histories who had little or no equity in their homes, the value of the securities plummeted.

Waxman and other lawmakers read from several documents that had previously not been disclosed publicly and that showed officials at the rating agencies believed there was little basis for giving gilt-edged ratings to subprime mortgage-related securities. The documents suggested they did so anyway to be competitive, and because it was lucrative business.

Among the documents, Waxman read from a presentation that Ray McDaniel, the chief executive officer of Moody's, gave last October to the rating agency's board of directors, in which he said that Moody's faces a "dilemma" and a "very tough problem" because the market "actually penalizes" ratings quality in some sectors.

"It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want ratings downgrades; short-sighted bankers labor short-sightedly to game the rating agencies," he said. "Unchecked, competition on this basis can place the entire financial system at risk."

Other documents obtained by the committee include a transcript from a Moody's "managing director's town hall" meeting in September 2007, in which McDaniel essentially described a race to the bottom in terms of credit quality for structured securities, saying "our competition, Fitch and [Standard and Poor's], went nuts. Everything was investment grade. It didn't really matter..."

Asked about the remarks, McDaniel said: "I believe I was responding to a question that had to do with standards and the challenge of maintaining standards especially in good times when the marketplace may not be as attentive to identifying risks."

Several lawmakers said the rating agencies' conduct involved "gross incompetence," while others repeatedly read from a short series of instant messages sent by analysts at Standards & Poor's in which one said the agency would rate a deal even if it were "structured by cows."

That conversation was included in a July report on the agencies by the SEC that did not identify the analysts as Standard & Poor's employees. Sharma told Waxman that the language was inappropriate and unprofessional, but noted that the SEC "did not find any misconduct even in this case that they examined."

To which Waxman retorted: "It's hard to find misconduct if there's no standard for misconduct."

At the end of the hearing, Waxman told the rating agency officials: "You weren't the only ones at fault, but you were the gatekeepers."